

Bank of Canada: Getting ready to hike

In a hawkish shift, the Bank of Canada has decided to end its QE asset purchases immediately and has brought forward its guidance on the first rate hike to mid-2022. With the economy growing strongly, creating jobs and experiencing more sustained inflation, there is the real prospect of 100bp of rate hikes next year, and CAD should remain broadly supported



Bank of Canada Governor Tiff Macklem takes questions from reporters on the phone as he participates in a news conference at the Bank of Canada

Source: Shutterstock

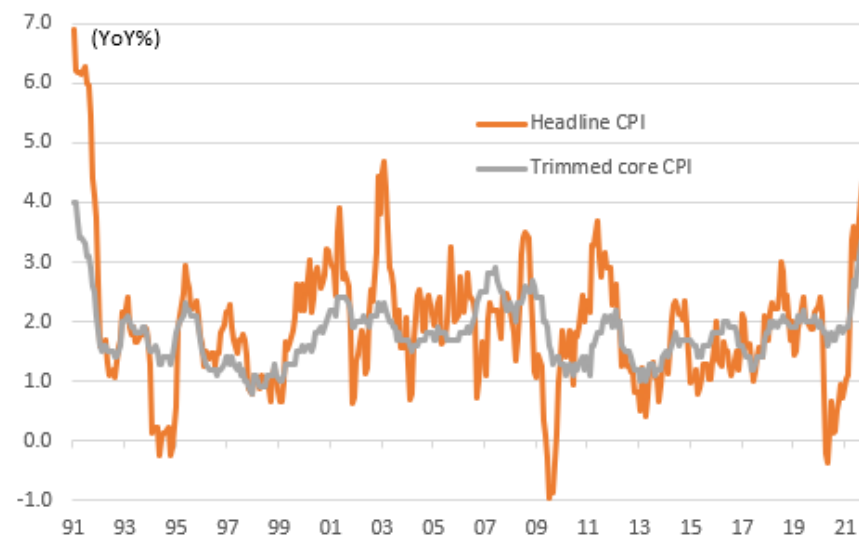
QE ended and earlier rate hikes signalled

Ahead of the meeting, the expectation was for the Bank of Canada to taper its weekly asset purchases from C\$2tn to C\$1tn and indicate that they would likely be concluded in December. Instead, we got a decidedly more hawkish outcome with a decision to end QE immediately and forward guidance on the timing of a likely rate hike moved from the second half of 2022 to "the middle quarters" of 2022.

The accompanying statement is very upbeat on both global and domestic economic prospects. Canadian GDP growth is forecast at 5% this year, 4.25% in 2022 and 3.75% in 2023, which is above the economists' consensus of 5%, 4% and 2.4%, respectively. The BoC expects growth to be

supported by strong consumer demand, business investment and a robust US growth story that will boost exports. Remember, too, that the energy sector makes up around 10% of the Canadian economy and the surge in prices will stimulate more drilling.

Canada inflation measures (YoY%)



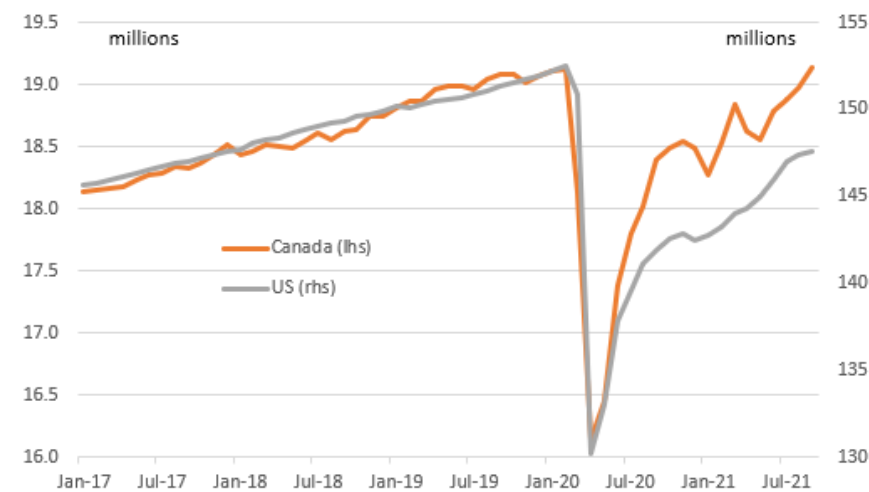
Source: Macrobond, ING

Inflation "stronger and more persistent"

The Bank is also more wary on inflation. September CPI came in at an 18-year high of 4.3% year-on-year, while the core trimmed measure is at a 30-year high, with the statement acknowledging that inflation pressures have been "stronger and more persistent than expected". The BoC highlights labour shortages in key sectors and manufacturing shortages and transportation bottlenecks, with rising energy costs set to further fan the flames.

BoC Governor Tiff Macklem has already admitted that supply chain strains and production bottlenecks "are not easing as quickly as we expected" which means that inflation is "probably going to take a little longer to come back down".

Employment: Canadian jobs market has outperformed the US's with all jobs lost now recovered



Source: Macrobond, ING

100bp for 2022?

We had been looking for two 25bp rates hikes in the second half of 2022, but with three hikes fully priced before today's hawkish shift in commentary, we are going to have to adjust our forecast. Significantly, employment is already at an all-time high, with 900 more people in work in September 2021 than in February 2020 while business surveys suggest a strong appetite to continue hiring. The problem is finding suitable staff.

In an environment of vibrant demand, this runs the risk that wage inflation builds and contributes to more prolonged price inflation in the economy. Consequently, the risks appear to be increasingly skewed towards the Bank of Canada hiking interest rates by a full percentage point in 2022.

CAD: Cementing its role as a popular bullish bet

USD/CAD dropped sharply following the BoC announcement, as the combination of ending QE and bringing forward the timing for a hike to "sometime in the middle quarters of 2022" pushed tightening expectations significantly higher. At the time of writing, the implied probability of a January 25bp rate hike is around 80%, with five rate hikes in total priced in for the next 12 months.

We doubt rate expectations can reasonably get more hawkish than this, but the Canadian dollar has now clearly cemented its role as a very attractive bullish bet, standing on the good side of the energy story and counting on an imminent tightening cycle. We'll be monitoring positioning indicators closely to see whether the loonie is seeing some overcrowding of speculative buyers.

Looking at CAD's outlook for the rest of 2021, our view is that we'd likely need to see some deterioration in market sentiment or witness a correction in oil prices for USD/CAD to stage a sustained rebound. That's because we do not expect the forthcoming data-flow in Canada to be detrimental to the loonie or to cause a significant re-pricing of rate expectations.

We are currently targeting 1.23 in USD/CAD as a year-end forecast, but given the faster-than-

expected move by the BoC and seasonal USD weakness in December, we see downside risks (i.e. USD/CAD closer to 1.20) to our scenario.

Authors

James Knightley

Chief International Economist

james.knightley@ing.com

Francesco Pesole

FX Strategist

francesco.pesole@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.